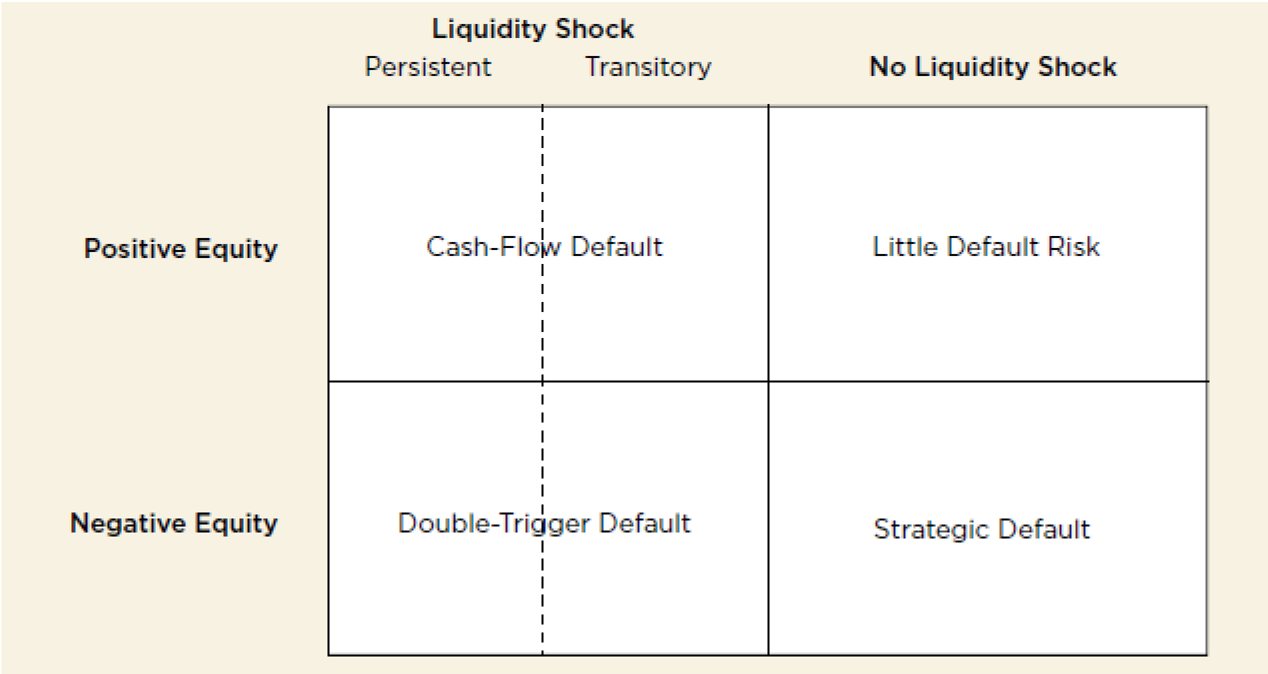
Chart of the Week – August 9, 2024

Taxonomy of Mortgage Default



Source: MBA's Research Institute for Housing America

Last week the Research Institute for Housing America (RIHA), MBA's think tank, released a special report, *Mortgage Design, Underwriting, and Interventions: Promoting Sustainable Homeownership*, that looks at the lessons learned from the Great Financial Crisis, the Covid-19 pandemic, and other past episodes of default, to understand how to design a more robust mortgage system that proactively supports sustainable homeownership.

This week's MBA Chart of the Week replicates Figure 1 from the report that the author, Dr. Joseph Tracy, uses to explain episodes of default. The figure outlines a taxonomy of mortgage defaults based on the borrower's equity position, whether the borrower faced a liquidity shock, and if so, the nature of the shock (i.e., persistent or transitory). For example:

- Strategic default, the SE quadrant in the figure, occurs when borrowers have the ability to pay their mortgage but choose to default due to being in negative equity.
- Double-trigger default, SW quadrant, occurs when a borrower is unable to pay their mortgage due to a liquidity shock – income or payment – and cannot sell their home due to negative equity.
- Cash-flow defaults, NW quadrant, occur when the borrower is unable to pay their mortgage due to a liquidity shock and chooses not to sell their home even though they have positive equity.

The paper provides further details on how to understand each taxonomic classification as its relative importance varies over time depending on changes in mortgage design, underwriting standards, and prevailing economic conditions.

Dr. Tracy's ability to analyze this complicated picture is a valuable tool for all mortgage practitioners and his comprehensive analysis not only examines how to proactively implement a well-designed intervention with a stressed borrower to minimize the loan's expected loss, but also considers the role governments can take, for example, by offering subsidies to interventions, in specific situations, as the U.S. Treasury did in the Home Affordable Modification Program.

Sustainable homeownership involves addressing the needs of borrowers to minimize defaults (i.e., targeting the right intervention to the right borrowers). To this end, Dr. Tracy recommends that as we move forward, we, as an industry, constantly reexamine our toolset and refocus our priorities on sustainability to ensure that future gains in the homeownership rate are enduring.

- Edward Seiler (eseiler@mba.org)